

## ***Query No. 9***

***Subject: Disclosure of changes in inventory of scrap in the Statement of Profit and Loss.***<sup>1</sup>

### **A. Facts of the Case**

1. A Company (hereinafter referred to as ‘the Company’) is a listed central public sector company formed under the Ministry of Defence. The Company has been set up with a view to achieve self-reliance in production and supply of various super alloys, titanium alloys, maraging steel and special steel materials to Defence and other strategic sectors for nuclear, aeronautical and space applications. The products manufactured are sold in the form of ingots, forged billets, sheets, plates, strips, rods, rings, etc.

2. The querist has stated that scrap is predominantly generated from the Company’s each manufacturing process, i.e., melting, forging and machining, etc. Further, with regard to nature of scrap, 90% of the scrap generated during manufacturing process will be re-usable in the production process of melting and only 10% of scrap, such as, turnings/end cut scrap, etc. is sold in the open market.

3. The Company’s production process starts from primary melting where the Company uses various raw materials purchased as per the required composition/specifications for an end-product in the melting process and the internally generated scrap is also used in majority volume based on requirement.

#### *Existing Practice*

4. The querist has further stated that the net accretion/decretion in scrap stock, i.e., difference of closing stock and opening stock of scrap is booked as ‘Consumption of raw material-internally generated scrap’ and the same is grouped under ‘Cost of Material Consumption’ in the Statement of Profit and Loss. The closing stock of scrap is disclosed under ‘Note 10 – Current Assets (Inventories)’ at estimated realisable value of scrap. The sale of scrap is being shown separately under ‘Other Operational Income’ under revenue from operations in the Statement of Profit and Loss.

5. During the reporting period, if scrap generation is more than the scrap consumption, the ‘consumption of raw material – internally generated scrap’ shows credit balance thereby reduces the amount of raw material consumption and vice-versa, i.e., if scrap consumption is more than the scrap generation, the consumption of internally generated scrap shows debit balance (net off scrap generation).

6. The querist has given the rationale for the existing practice as follows:

- a. Scrap generated during manufacturing process is re-usable as a raw material in the production process of melting.
- b. Paragraph 9.5.3 of the Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013, issued by the Institute of Chartered Accountants of India (ICAI) requires disclosure of difference in opening and closing inventories of finished goods (FG)/Work-in-Progress (WIP)/Stock-in-trade only in ‘changes in inventories of finished goods and work-in-progress’.

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<sup>1</sup> Opinion finalised by the Committee on 12.5.2022.

- c. No guidance is available regarding disclosure of changes in scrap inventory in the Guidance Note or in the Standard.
- d. In the absence of any guidance for disclosing the accretion/ decretion of scrap, the same is being consistently shown as part of raw material consumption for the past several years.

7. According to the querist, as per recent opinion given by the Expert Advisory Committee (EAC) of the ICAI dated 07.05.2021 (published in May 2021, ICAI Journal), when scrap generated during manufacturing process is not usable and there is no other use of such items except disposal as scrap, such scrap inventories can be shown as ‘Changes in Inventory of Scrap’ in the Statement of Profit and Loss.

8. During recent deliberations in the Company, it was discussed that consumption of raw material – internally generated scrap shows credit balance when scrap generation is more than the consumption and this resulted in understatement of raw material consumption for the particular period.

9. It is also submitted by the querist that the materials procured and used in the manufacturing process will be considered as raw material consumption. The raw materials may be basic raw materials required for production process. Further, any material which is in the form of intermediary product, if purchased, is also being treated as raw material and whenever such material is consumed, the same is shown as raw material consumption. However, in case of intermediary products produced and re-used in the subsequent process, these will always affect the inventory accretion/decretion, i.e., intermediary items in the stock if it is increasing work-in-progress (WIP) over the period, beginning and ending and vice versa.

10. It is also to be noted that the value of scrap generation/consumption clubbing under raw material consumption affecting certain ratios which are required to be calculated for Memorandum of Understanding (MOU) purpose. Department of Public Enterprise (DPE) confirmed that all ratios are to be arrived based on accounts as published. Sometimes certain WIP which is good will be changed to scrap due to rejection or sale as scrap and such adjustments affect the figures of change in inventory and raw material consumption.

11. For easy understanding of the issue, present practice followed in the Company and proposed practice are tabulated by the querist as below:

Present Practice

<b>Description</b>	<b>Journal Entry</b>	<b>Grouping in Statement of P&amp;L</b>
Increase in Scrap Inventory (Scrap generation is more than consumption)	Scrap Inventory A/c Dr.  Consumption of Raw Material – Internally generated scrap Cr.	Cost of Raw Material Consumption
Decrease in Scrap Inventory (Scrap consumption is more than generation)	Consumption of Raw Material – Internally generated scrap A/c Dr.  Scrap Inventory Cr.	Cost of Raw Material Consumption

Proposed Practice

Description	Journal Entry	Grouping in Statement of P&L
Increase in Scrap Inventory (Scrap generation is more than consumption)	Scrap Inventory A/c Dr. Changes in Scrap Inventory Cr.	Changes in Finished Goods/Work-in-progress
Decrease in Scrap Inventory (Scrap consumption is more than generation)	Changes in Scrap Inventory A/c Dr. Scrap Inventory Cr.	Changes in Finished Goods/Work-in-progress

Practical Example for present and proposed practice in the Statement of Profit and Loss

**Cost of Raw Material Consumption**

Existing		Proposed	
Description	Amount (Rs.)	Description	Amount (Rs.)
Gross Raw Material consumption (Direct purchase from Market)	1,00,000	Gross Raw Material Consumption (Direct purchase from market)	1,00,000
<b>Add</b>			
<b>(Accretion)/Decretion of Scrap value (Opening – Closing)</b>	<b>(30,000)</b>		<b>-</b>
<b>Net Raw Material Consumption</b>	<b>70,000</b>		<b>1,00,000</b>

Changes in Inventory of Finished goods /Work-in-progress

Existing		Proposed	
Description	Amount (Rs.)	Description	Amount (Rs.)
Change in Inventory of FG and WIP (Increase)	(2,00,000)	Change in Inventory of FG and WIP	(2,00,000)
<b>Add</b>			
<b>(Increase)/Decrease in Scrap</b>	<b>-</b>		<b>(30,000)</b>
<b>Change in Inventory of FG and WIP</b>	<b>(2,00,000)</b>		<b>(2,30,000)</b>

It is also informed that there is no change in the total expenses and profit amount under both the practices.

## **B. Query**

12. The querist has sought the opinion of the Expert Advisory Committee as to whether the Company can change the grouping of net scrap generated under 'Change in Inventories of finished goods, work-in-progress and stock-in-trade' instead of 'Cost of Raw Material Consumption' in the Statement of Profit and Loss.

## **C. Points considered by the Committee**

13. The Committee notes that the basic issue raised by the querist relates to presentation of the inventory of items/products (classified as 'scrap'), generated during the manufacturing process and consumed/used in the further production process of the Company, in the Statement of Profit and Loss. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for scrap sold, impact of presentation of scrap on certain ratios required to be calculated for MoU or other purposes and computation of such ratios, accounting for products (other than scrap) produced and re-used in the subsequent process, accounting for raw materials procured and used in the manufacturing process, accounting for WIP changed to scrap due to rejection or sale as scrap and its consequent adjustments, appropriateness of classification of the items/product generated during the manufacturing process in the extant case as scrap and measurement thereof, etc. The Committee, while expressing its opinion has laid down the accounting principles to be followed and has not examined the appropriateness/accuracy of journal entries and the example furnished by the querist for present and proposed practice in the Statement of Profit and Loss. The Committee wishes to point out that the Accounting Standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time. Further, the opinion expressed hereinafter is purely from accounting perspective and the Committee has not examined any legal, taxation or financial management issues.

14. At first, the Committee examines the nature of items/products (classified as 'scrap') in the extant case in the context of accounting requirements and notes the following paragraphs of Indian Accounting Standard (Ind AS) 2, 'Inventories':

**“6 Inventories are assets:**

**(a) held for sale in the ordinary course of business;**

**(b) in the process of production for such sale; or**

**(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”**

“14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this

value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.”

From the above, the Committee notes that during a production process, more than one product may be produced simultaneously which, for example, may either be joint products or a main product and a by-product. Further, although the Standard does not mention about the scrap or waste products; the Committee notes that scrap or waste products are also the result of production process and if these could be sold or used/consumed internally, these can be considered as ‘inventories’. In this context, the Committee also notes that the items/products generated/produced during the manufacturing process in the extant case are either used in further production process or sold in the open market. Therefore, the Committee is of the view that materials/items generated in the manufacturing process which would be further used as input in the production process of melting can be considered to be ‘in the process of production for sale’ and accordingly, can be considered as ‘inventories’ as per paragraph 6(b) of Ind AS 2. Thus, the disclosure requirements of Schedule III to the Companies Act, 2013 are equally applicable to these items/products (classified as ‘scrap’ by the Company) as to the inventories of raw materials, finished goods, work-in-progress, etc.

15. Now, the Committee examines the issue raised by the querist relating to disclosure of changes in the afore-mentioned inventory of ‘scrap’ used in the production process in the Statement of Profit and Loss. In this context, the Committee notes that Part II, ‘Statement of Profit and Loss’ under Division II of Schedule III to the Companies Act, 2013 requires the aggregate of the following expenses to be disclosed on the face of the Statement of Profit and Loss:

- Cost of materials consumed
- Purchases of Stock-in-Trade
- Changes in inventories of finished goods, work in progress and Stock-in-Trade
- Employee benefits expense
- Finance costs
- Depreciation and amortization expense
- Other expenses

The Committee further notes the following paragraphs of Guidance Note on Division II - Ind AS Schedule III to the Companies Act, 2013 (Revised January, 2022 edition), issued by the ICAI (hereinafter referred to as ‘the Guidance Note’):

#### **“9.5. Expenses**

**The aggregate of the following expenses are to be disclosed on the face of the Statement of Profit and Loss:**

- *Cost of materials consumed*
- Purchases of Stock-in-Trade
- *Changes in inventories of finished goods, work in progress and stock in trade*
- Employee benefits expense

- Finance costs
- Depreciation and amortization expense
- Other expenses

#### ***9.5.1. Cost of materials consumed***

This disclosure is applicable for manufacturing companies. Materials consumed would consist of raw materials, packing materials (where classified by the company as raw materials) and other materials such as *purchased* intermediates and components which are ‘consumed’ in the manufacturing activities of the company. Where packing materials are not classified as raw materials the consumption thereof should be disclosed separately. However, *intermediates and components which are internally manufactured are to be excluded from the classification.*

**9.5.1.1.** For purpose of classification of inventories, internally manufactured components may be disclosed as below:

- (i) where such components are sold without further processing they are to be disclosed as ‘finished products’.
- (ii) where such components are sold only after further processing, the better course is to disclose them as ‘work-in-progress’ but they may also be disclosed as ‘manufactured components subject to further processing’ or with such other suitable description as ‘semi-finished products’ or ‘intermediate products’.
- (iii) where such components are sometimes sold without further processing and sometimes after further processing it is better to disclose them as ‘manufactured components’.”

**9.5.1.6.** In the case of industries where there are several processes, materials may move from process to process, so that the finished product of one department constitutes the raw materials of the next. The consumption of raw materials for production of such intermediates would have to be accounted as raw materials consumed and so, it follows that *internal transfers from one department to another should be disregarded in determining the consumption figures to be disclosed.*”

#### **9.5.3. Changes in inventories of finished goods, work-in-progress and stock-in-trade**

This requires disclosure of difference between opening and closing inventories of finished goods, work-in-progress and stock-in-trade. The difference should be disclosed separately for finished goods, work in progress and stock in trade.”

(Emphasis supplied by the Committee.)

The Committee notes from the requirements of Guidance Note in the context of disclosure of ‘Expenses’ in the Statement of Profit and Loss, as reproduced above, that ‘materials consumed’ would consist of materials, such as *purchased* intermediates and components which are ‘consumed’ in the manufacturing activities of the company. The cost of intermediates or components which are internally manufactured and transferred from one department to another within the same entity should be excluded from the cost of materials

consumed. Thus, only purchased and not internally manufactured and transferred intermediates can be included in the 'cost of materials consumed'.

Accordingly, the Committee is of the view that in the extant case, the inventories of intermediates or items/products, internally manufactured and transferred from one department to another within the Company should be considered as work-in-progress and presented under 'Changes in inventories of finished goods, work-in-progress and stock-in-trade' under 'Expenses' in the Statement of Profit and Loss as per the requirements of Schedule III to the Companies Act, 2013 with appropriate disclosures to explain the nature of inventory. Further, while presenting, the requirements of paragraph 9.5.1.1 of the Guidance Note should also be considered.

**D. Opinion**

16. On the basis of the above, the Committee is of the opinion that internally generated items/products (classified as 'scrap'), used in the production process and transferred from one department to another within the Company should not be presented as 'cost of materials consumed'; rather should be considered as work-in-progress and presented under 'Changes in inventories of finished goods, work-in-progress and stock-in-trade' under 'Expenses' in the Statement of Profit and Loss as per the requirements of Schedule III to the Companies Act, 2013 with appropriate disclosures to explain the nature of inventory. Further, while presenting, the requirements of paragraph 9.5.1.1 of the Guidance Note should also be considered, as discussed in paragraph 15 above.

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